Defining Indirect Expropriation: The TTIP Approach and the (Elusive) Search for 'Greater Certainty'

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Abstract

The paper assesses the definition of indirect expropriation included in the recent EU proposal within the context of the TTIP negotiation. The paper argues that, while the EU proposal is likely to have narrowed the scope of the concept of indirect expropriation, in terms of providing 'greater clarity', we are not there yet. Like similar attempts before it, the EU proposal refers to a variety of different legal approaches without sufficiently clarifying their content and relationship. While this lack of clarity emphasizes the indecision among policy makers, including the EU, about where to draw the line between an indirect expropriation and a legitimate regulatory measure, it ultimately suggests that there are still doubts about the proper function of international investment law.

1 INTRODUCTION

A provision requiring host States to compensate for the expropriation of foreign investments is one of the few constants in the more than three thousand international investment treaties concluded in the last sixty years or so. Most of these treaties adopt what appears to be a potentially broad definition of expropriation expressly referring to both 'direct' and 'indirect' expropriations and/or 'measures having an effect equivalent to' expropriation. While there is little controversy in relation to 'direct expropriation', investment tribunals have interpreted the concept of 'indirect expropriation' in different ways. In oversimplified terms, arbitral decisions have differed principally in the different relevance attributed to the measure's adverse effect on the foreign investment, on the one hand, and the measure's public policy purpose, on the other.[2] Moreover, there are additional issues that remain disputed with regard to each of the two key factors (adverse effect and public policy objective): (a) should the adverse effect (or deprivation) on the investment be 'substantial' or 'total'? (b) Should tribunals measure the adverse effect with reference to, specifically, the investor's 'property interests' in the investment or, more generally, the 'value' of the investment affected by the host State's conduct? (c) May any public policy

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[2] While the initial predominant approach in arbitral practice was based on the so-called 'sole effect' doctrine (whereby a finding of 'indirect expropriation' is premised exclusively on an analysis of the substantial adverse impact of the host State conduct on the foreign investment), subsequent investment tribunals have at times also taken into account the public policy underlying the conduct at issue, relying on the so-called 'police powers' doctrine. Andrew Newcombe & Lluis Paradell, *Law and Practice of Investment Treaties* (Kluwer, 2009) at 322 et seq.

goal justify a substantial deprivation? (d) Does the review of the legitimacy of the host State's conduct entail a reasonableness or proportionality analysis?[3]

While in practical terms, it may be argued that there are nowadays more important treaty provisions protecting foreign investment (particularly the fair and equitable treatment clause),[4] the controversy over the proper definition of indirect expropriation still highlights the broader debate over the appropriate restraints imposed by international investment treaties on States' regulatory authority for purposes of promoting the flow of foreign investment and thus the prosperity of the treaty's contracting parties. The essence of this debate is captured by the discussion within the European Union (EU) on the shape of future EU investment agreements,[5] particularly in the context of the negotiation of the Transatlantic Trade and Investment Partnership (TTIP) between the EU and the United States. The two contracting parties have recognized two key challenges. The first challenge is to find the right balance between granting 'the highest possible level of protection' to foreign investors and safeguarding States' ability 'to adopt and maintain measures necessary to regulate in the public interest to pursue certain public policies'.[6] The second challenge is to improve the clarity and predictability of investment treaties principally (a) to allow host States and investors to appreciate (and comply with) the rules applicable to their relationship and (b) to decrease the high level of discretion currently entrusted on to ad hoc investment tribunals to decide the legitimacy of public interest regulations.[7]

The aim of the paper is to critically assess the definition of indirect expropriation included in the recent EU Proposal for Investment Protection and Resolution of Investment Disputes[8] and determine whether the two mentioned challenges have been sufficiently addressed by such proposal.

The EU Proposal on expropriation is part of a wider trend recently followed by policy makers with the aim of introducing greater clarity with regard to the

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[3] See Jonathan Bonnitcha, *Substantive Protection under Investment Treaties* (CUP, 2014) at 255.

[4] Michael Reisman and Rocio Digon "Eclipse of Expropriation" in Arthur Rovine (ed), *Contemporary Issues in International Arbitration and Mediation – The Fordham Papers 2008* (Martinus Nijhoff, 2009) at 27 et seq.

[5] *See* August Reinisch, *The Future Shape of EU Investment Agreements*, 28 ICSID Review 179 (2013).

[6] *See* the 2012 *Statement on Shared Principles for International Investment* by the European Union (EU) and the United States.

[7] *See also* European Parliament Resolution on the Future of the European International Investment policy (6 April 2011) 2010/2203(INI), para 24.

[8] See European Union's proposal for Investment Protection and Resolution of Investment Disputes tabled for discussion with the United States and made public on 12 November 2015, http://trade.ec.europa.eu/doclib/docs/2015/november/tradoc_153955.pdf (accessed 23 June 2016) [hereinafter EU Proposal].

concept of indirect expropriation directly in the text of investment treaties.[9] The paper's focus on the EU Proposal, in particular, stems from the perception that the recent entry of the EU (and consequently the European Commission) in the global policy debate on international investment law represents a game changer. First, the EU is one of the powerhouses when it comes to international economic relations and thus it has the ability to influence (if not impose) its choices on to most other economic partners. Second, the EU is now exclusively competent when it comes to foreign direct investment and has embarked on an ambitious negotiating trade and investment agenda with several major economies (such as Canada, India, Vietnam, Singapore, China, United States) with the particular aim to eventually replace the more than 1000 investment treaties signed in the past by EU Members States. Third, the EU is a very diverse entity including, for example, in its membership historically capital exporting (such as Germany, the Netherlands, United Kingdom) and capital importing countries (such as the Czech Republic, Poland and Hungary) with different experiences and perceptions when it comes to international investment law and arbitration.[10] In short, there is little doubt that the EU will play a pivotal role in shaping the evolution of the international investment law regime and thus there exist a particularly high level of expectations (and trepidations) over what the EU will do in this field.

The paper argues that, while the EU Proposal is likely to have narrowed the scope of the concept of indirect expropriation, in terms of providing 'greater clarity', we are not there yet. Like similar attempts before it, the EU Proposal refers more or less expressly to a variety of legal approaches without sufficiently clarifying their content and relationship. While this lack of clarity clearly emphasizes the indecision among policy makers, including the EU, about where to draw the line between an indirect expropriation (that entails compensation) and a legitimate regulatory measure (that does not), it ultimately also suggests that there are still doubts about what should be the proper function of international investment law.

Mirroring the relevant text of the EU Proposal, the paper is divided in four main sections or 'acts'. In Act I, the paper first addresses the main provision on expropriation found in Article 5 of the proposed text (section 2). In the three subsequent acts, the paper examines in order each of the three paragraphs of the Annex on Expropriation (sections 3, 4 and 5). The paper employs the theatrical metaphor to highlight the existence of an overall plot and at the same time the specificity of each individual part.

2 ACT I: ARTICLE 5 AND THE CONTINUITY WITH PAST TREATY PRACTICE

Article 5 of the 2015 EU Proposal embodies the relevant provisions on expropriation. Paragraph 1 of Article 5 reads as follows: 'Neither Party shall nationalize or expropriate a covered investment either directly or indirectly

[9] *See* UNCTAD, *IIA Issues Note: Taking Stock of IIA Reform* (2 March 2016) at 8-9.
[10] *See* Federico Ortino and Piet Eeckhout, *Towards an EU Policy on Foreign Direct Investment*' in Andrea Biondi et al (eds), *EU Law After Lisbon* (Oxford, OUP 2012) at 321-2.

through measures having an effect equivalent to nationalisation or expropriation'.

The immediate reaction to Article 5 on Expropriation is that there is no change compared with the text of expropriation provisions of many existing investment treaties. However, Article 5.2 adds the following language: 'For greater certainty, this paragraph shall be interpreted in accordance with Annex I [on expropriation]'.

As the reader will surely know, this is not a novel strategy. The United States (and Canada) appear to have been the first to introduce a similar approach in their 2004 model bilateral investment treaties (and subsequently in their investment treaty practice). While it is beyond the scope of this contribution to examine the specific reasons behind those changes,[11] it is fair to say that a key part of their strategy was to bring about clarity particularly with regard to the notion of 'indirect expropriation'. More importantly, clarifying the notion of indirect expropriation through an annex appended to the new (model) treaty has one key advantage: it strengthens the continuity with past treaty practice. At least in terms of the basic provision on expropriation, the new approach does not involve any major re-elaboration of the very notion of expropriation, which still refers to both 'direct' and 'indirect' forms linking the latter concept with the phrase 'measures having an effect equivalent'. More fundamentally, the approach based on keeping the original language in the basic provision on expropriation but adding a clarification in an annex to the treaty may have the additional effect of influencing how investment tribunals would interpret *existing* investment treaties, which do not include such an annex.[12]

There are however, also risks with an approach based on preserving continuity with past treaty practice. First, relying on the traditional wording at least for purposes of the basic provision on expropriation has the potential risk of maintaining the traditional level of uncertainty with regard to the very concept of indirect expropriation. Second, and more fundamentally, relying on the traditional wording may preserve the (more or less apparent) treaty's emphasis on affording a high level of protection to foreign investment to the detriment of the host State's regulatory sovereignty. In other words, mere reference to the measure's 'effect' on the investment may lead (at least some) tribunals to continue to focus on the measure's substantial adverse effect on the investment notwithstanding the legitimacy and reasonableness of the public policy being pursued by the host State. In many ways, whether these risks will actually

[11] For a detailed discussion of the 2004 and 2012 US model treaties *see* Andrea Menaker, *Benefitting from Experience: Developments in the United States' Most Recent Investment Agreements*, 12 U.C. Davis J. Int'l L. & Pol'y 121 (2005) and Lee Caplan and Jeremy Sharpe, *United States* in Chester Brown (ed), *Commentaries on Selected Model Investment Treaties* (Oxford, OUP 2013) at 755 et seq., respectively.

[12] The decision of the tribunal in *Methanex v United States* (Award, 7 August 2005) may provide the best evidence for such additional impact.

materialise will principally depend on the very content of the clarification included in the relevant Annex. Let us now turn to it.

3 ACT II: THE ANNEX ON EXPROPRIATION AND THE MEANING OF 'MEASURES WITH AN EFFECT EQUIVALENT TO DIRECT EXPROPRIATION'

In addition to defining the notion of 'direct expropriation', the opening paragraph of the Annex reiterates the relevance of the 'effect' of the measure under review for purposes of defining 'indirect expropriation by stating that 'indirect expropriation occurs where a measure or series of measures by a Party has an effect equivalent to direct expropriation'. The first paragraph, however, goes further (than any other existing treaties) specifying that a measure (or series of measures) has such effect if 'it substantially deprives the investor of the fundamental attributes of property in its investment, including the right to use, enjoy and dispose of its investment, without formal transfer of title or outright seizure'. Let us focus on the following two key issues: the 'quantum' of deprivation ('substantial') and the 'object' of deprivation ('fundamental attributes of property').

'Substantial deprivation' is a well-known phrase in investment arbitral practice and has been often referred to by tribunals interpreting indirect expropriation based on either the 'sole effect' or 'police powers' doctrines. It appears however, to be the first time that such phrase has been codified in the (draft) text of an investment treaty (as neither the US nor the Canadian model treaties refer to it) in connection with the notion of 'measures with an effect equivalent to direct expropriation'.

In one sense, the codification settles the debate surrounding the required magnitude of the deprivation. While most tribunals set the bar just below 'total' deprivation,[13] some investment tribunals appear to have adopted an approach requiring a higher level of deprivation. For example, for purposes of defining a measure equivalent to expropriation, the tribunal in *Venezuela Holdings v Venezuela* stated that 'deprivation requires either a total loss of the investment's value or a total loss of control by the investor of its investment, both of a permanent nature.'[14]

In another sense, however, codifying the concept of 'substantial deprivation' may not have brought much clarity in the test for indirect expropriation. Tribunals have indeed resisted providing clear guidance on the level of interference that is required to establish 'substantial deprivation', emphasising the 'fact-sensitive' nature of the assessment.[15]

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[13] *Metalclad v Mexico*, Award, 30 August 2000, para. 103.

[14] *Venezuela Holdings BV, Mobil Cerro Negro Holding LTD et al v Venezuela*, Award, 9 October 2014, para. 286. *See also Tecmed v Mexico*, Award, 29 May 2003, para. 115 and *Cargill v Mexico*, Award, 18 September 2009, para. 360 (referring to 'radical' deprivation).

[15] *Chemtura v Canada*, Award, 2 August 2010, para. 249.

Moreover, the reference to 'substantial deprivation' does not seem to settle the so called 'denominator' problem: in order to determine whether the host State has caused 'substantial' deprivation of the investment a tribunal needs first to identify the (contours of the) investment itself.[16] In investment treaty arbitration, the issue of 'partial' expropriation is indeed a controversial one as some tribunals have expressly denied the very concept of partial expropriation and other tribunals have expressly recognized it.[17]

Contrary to the concept of 'substantial deprivation', the phrase 'fundamental attributes of property' is not one that investment tribunals have used in addressing expropriation claims. The closest I have come across something similar at the international level is in *Tippets*, where the Iran-US Tribunal stated that a taking of property includes the case where "the owner was deprived of fundamental rights of ownership".[18] It may also be linked with notions developed within North American or European domestic legal systems. For example, some French scholars identify the right to use, benefit and dispose of the property as the three '*attributs du droit de propriété*' (to be distinguished from the '*caractères du droit de propriété*', ie., that the right is absolute, exclusive and perpetual).[19]

The key issue here is identifying the 'object' of the deprivation. In the absence of any textual reference, investment tribunals have focused on a variety of aspects including the deprivation of the control, use, benefit, enjoyment, value of the investment. For example, the *Metalclad* tribunal referred to deprivation 'of the use or reasonably-to-be-expected economic benefit of property'.[20] The *Tecmed v Mexico* tribunal referred first to the deprivation 'of the economical use and enjoyment of [the claimant's] investments, as if the rights related thereto—such as the income or benefits related to the Landfill or to its exploitation—had ceased to exist'; it then specified that the relevant inquiry focused on whether 'the assets involved have lost their value or economic use for their holder and the extent of the loss.'[21] The *Chemtura* tribunal referred to deprivation of 'the benefit

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[16] Alessandra Asteriti, *Regulatory Expropriation Claims in International Investment Arbitrations: A Bridge Too Far?* in Andrea Bjorklund (ed), *Yearbook of International Investment Law and Policy* (2012-13) at 462.

[17] *See* Ursula Kriebaum, *Partial Expropriation*, 8 JWIT 69 (2007).

[18] *Tippets, Abbett, McCarthy, Stratton v TAMS-AFFA Consulting Engineers of Iran*, Iran-US Claims Tribunal, 22 June 1984, 6 *Iran-US CTR* 219, 225. *See also* the reference to "fundamental right of ownership" in *Mezzanine v Hungary*, Award, 17 April 2015, para. 178.

[19] Pierre Voirin and Gilles Goubeaux, *Doit Civil – Tome 1* (Paris, L.G.D.J. 2013) 255 et seq. See also the request to the Constitutional Council relating to its Decision 85-189 DC, 17 July 1985, where the right to dispose is referred to as an '*attribut fundamental*', '*attribut essentiel*', and '*attribut capital*' of property. [I am indebted to Dr Florian Grisel for this reference]. *See also* the reference to the concept of 'fundamental attributes of property ownership' in US takings law such as in *Guimont v. Clarke* 121 Wn.2d 586 (1993) 854 P.2d 1.

[20] *Metalclad*, *supra* at ?, para. 103.

[21] *Tecmed*, *supra* at ?, para. 115.

of' the claimant's investment.[22] The tribunal in *Glamis* referred to impairment of 'the investor's economic rights, ie., ownership, use, enjoyment or management of the business' as well as to deprivation of the 'economic value' of the claimant's investment.[23] The tribunal in *Venezuela Holdings v Venezuela* equated the required deprivation to either a total loss of the investment's value or a total loss of control by the investor of its investment'.[24]

Tribunals tend to list several of the factors mentioned above (e.g., control, use, benefit, enjoyment, value) but they chose different combinations. More problematically, it is not altogether clear whether each factor is individually sufficient in order to establish an expropriation or whether they are cumulative requirements. In selecting the relevant factors, tribunals use unfortunately different conjunctions ('and' or 'or'). It is clear, however, that each individual factor has its own specific meaning and thus applying one factor over another one may, depending on the circumstances of the case, lead to different results. For example, there may be cases where the host State's measure under review has (substantially) deprived the investor of its control over the investment without having (at least substantially) deprived the investment of its value and vice versa.

It is not clear whether the language chosen in the Annex on Expropriation proposed by the EU, referring to deprivation of 'the fundamental attributes of property' codifies (at least in part) existing investment arbitral practice or whether it purports to introduce a novel concept. The Annex does specify that 'the right to use, enjoy and dispose of its investment' are examples of such fundamental attributes. As the list appears to be indicative, it is not clear whether there exist any other fundamental attributes of property beyond the three expressly mentioned. For example, is the investor's right to the 'value' of its investment a fundamental attribute of property? And, even if that were not the case, could an investor claim that a substantial reduction of the value of its investment (due to the host State's conduct) is enough to demonstrate a 'substantial deprivation' of its right to use or enjoy or even dispose of its investment? Would a tribunal require a stronger link between the host State's conduct and the fundamental attribute of property being affected? Take the example of a minority shareholding in a locally incorporated company being the relevant protected investment. The foreign investor claims that the host State's conduct has revoked the local company's necessary license to operate its business and thus negatively affected the value of the claimant's shareholding in the local company. While the revocation of the license did not *directly* interfere with any of the fundamental property attributes of the protected investment (shareholders' rights to appoint directors, or receive dividends, formally still exist), one may argue that the revocation did have an *indirect* impact on the fundamental attributes of property: without the license, the local company cannot operate and thus the right to use, enjoy and dispose of the shareholding have for all practical purposes being deprived.

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[22] *Chemtura v Canada*, Award, 2 August 2010, para 247.
[23] *Glamis Gold v United States*, Award, 8 June 2009, paras 357-58.
[24] *Venezuela Holdings*, *supra* n. ?, para. 286.

In conclusion, while paragraph 1 of the Annex emphasizes the relevance of the 'effect' of the measure under review for purposes of defining the notion of 'indirect expropriation' (in line with the sole-effect doctrine), uncertainty remains with regard to both the 'quantum' and the 'object' of the necessary deprivation.

4 ACT III: THE ANNEX AND THE 'CASE-BY-CASE INQUIRY'

In paragraph 2, the Annex changes tack and links the determination of an indirect expropriation to a 'case-by-case inquiry' based on a variety of factors including principally the 'economic impact' and 'object and content' of the measure. Paragraph 2 of the Annex states as follows:

> The determination of whether a measure or series of measures by a Party, in a specific fact situation, constitutes an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors:
>
> (a) the economic impact of the measure or series of measures, although the sole fact that a measure or series of measures of a Party has an adverse effect on the economic value of an investment does not establish that an indirect expropriation has occurred;
> (b) the duration of the measure or series of measures by a Party;
> (c) the character of the measure or series of measures, notably their object and content.

The language is very similar (but by no means identical) to that found in the parallel Annex on expropriation put forward for the first time by the United States in its 2004 model investment treaty. The US approach is, in turn, a codification of the case-by-case test enunciated by the United States Supreme Court in *Penn Central Transport Co. v New York City*,[25] which constitutes one of the key components of US constitutional law on regulatory taking (the so-called *Penn Central* test).[26]

If the first paragraph of the Annex reiterates the continued validity of the sole effect doctrine for purposes of determining an indirect expropriation, the second paragraph appears to embrace an approach based on a broader inquiry that includes both the impact and character of the measure under review. The latter approach is thus closer to the approach adopted by those investment tribunals that have referred to the host State's police powers as one of the relevant factors in establishing indirect expropriation.

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[25] 438 U.S. 104 (1978).

[26] *See* Parvan Parvanov & Mark Kantor, *Comparing US Law and Recent US Investment Agreements: Much More Similar than you Would Expect*, in Andrea Bjorklund (ed), *Yearbook on International Investment Law and Policy 2010-2011* (OUP, 2012) at 767.

Thus, the first key question that confronts the reader revolves around the relationship between the two (apparently conflicting) criteria identified in the first two paragraphs of the Annex in order to determine an 'indirect expropriation' ('substantial deprivation of the fundamental attributes of property' v 'case-by-case inquiry'). As the Annex does not provide any clue on the nature of the relationship, several options are available. A first option is a 'rule v exception' relation, whereby substantial deprivation will lead to a finding of indirect expropriation unless the outcome of the case-by-case inquiry shows the strength of the public policy aim being pursued by the measure under review.[27] A second option is a 'threshold v norm' relation, whereby substantial deprivation only represents a necessary preliminary threshold test that the claimant has to overcome before the case-by-case inquiry is performed in order to determine whether the host State's measure constitutes an indirect expropriation.[28] While these first two options are relatively similar, they differ in the relevance attributed to each element: the emphasis in the first option is on the 'substantial effect', while the emphasis in the second option is on the case-by-case analysis. A third option is a '*per se* taking v rule of reason' relation, whereby cases of 'substantial deprivation' will automatically lead to a finding of indirect expropriation, while other cases involving lesser forms of deprivation, are subject to the case-by-case analysis based on a variety of factors.[29] A fourth option is to subsume 'substantial deprivation' into the 'case-by-case analysis', which includes, after all, taking into account the 'economic impact of the measure'.[30]

A second related question deals with the very nature of the case-by-case inquiry put forward in the second paragraph of the Annex. First, the list of relevant factors is merely indicative, thus there may be additional factors to be taken into account. For example, in the US constitutional jurisprudence as well as in US treaties concluded based on the 2004 model, one of the key factors, which is not included in the EU Proposal, is 'the extent to which the government action interferes with distinct, reasonable investment-backed expectations'.[31] The three factors listed – the economic impact, duration and character of the measure – may need some fleshing out. For example, is the reference to the measure's 'economic impact' meant to be to the measure's impact on the specific investment or does it include a broader assessment? It is not clear whether the language expressly noting that 'the sole fact that a measure […] has an adverse effect on the economic value of an investment does not establish that an indirect

[27] *See Chemtura v Canada*, *supra* n. ?.
[28] *See Glamis Gold*, *supra* n. ?, para. 357.
[29] This option reflects US law on regulatory taking as shown in Parvanov & Kantor, *supra* n. ?, at 767.
[30] This appears to be the approach adopted by the tribunal in *Railroad Development Corporation v. Guatemala*, Award, 29 June 2012. See Asteriti, *supra* n. ?, at 464.
[31] This additional factor is included in the most recent version of the Comprehensive Economic and Trade Agreement (CETA) between Canada and the EU (see Annex 8-A on Expropriation). Text was released to the public for information purposes on 29 February 2016.

expropriation has occurred' provides a definitive answer one way or the other to this question.[32]

More fundamentally, it is not clear what kind of case-by-case inquiry a future tribunal will perform based on the language of paragraph 2 of the Annex. Such language may entail a variety of tests involving different levels of intrusiveness in the regulatory prerogatives of States.[33] At the lower end of the intrusiveness spectrum, the case-by-case approach may simply require the existence of a rational connection between the means used and the governmental objective sought to be achieved (ie., the conduct adopted is likely to achieve at least in part the legitimate policy aim). This option does not appear likely as the means-end test does not focus on the economic impact of the measure but rather on the extent to which the measure contributes to the chosen policy goal.

A more plausible option is to read the case-by-case inquiry as requiring that the conduct chosen by the host State entails the lowest possible burden to achieve the specific policy goal (ie., the conduct adopted is the most cost-effective in achieving the legitimate policy aim). A cost-effectiveness test does need to consider both the adverse impact on the investment and the ability of one or more measures to achieve the chosen policy objective.

At the other end of the spectrum, and equally plausible, the case-by-case approach in paragraph 2 may entail a strict balancing between the costs imposed on the investor's property and the benefits of the public regulatory action. Under this test, the tribunal will need to determine whether the measure's impact on the investor is proportional to the legitimate policy aim.

These three distinct tests are neatly captured by the three prongs – 'suitability', 'necessity' and 'strict proportionality' – of the principle of proportionality, which finds its modern origin in German public law and its application in various domestic, regional and international legal systems.[34]

Lastly, paragraph 2 is also not clear with regard to the intensity of the review to be carried out by an investment tribunal. Should the tribunal subject the public

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[32] The statement does provide a strong indication that an assessment of whether a measure has had a 'substantial deprivation' for purposes of paragraph 1 of the Annex should not be based, at least exclusively, on the measure's impact on the 'value' of the investment.

[33] For example, US constitutional jurisprudence on regulatory takings has not simply evolved over the years, but it is marred by uncertainty and vagueness. David Schneiderman *Constitutionalizing Economic Globalization: Investment Rules and Democracy's Promise* (CUP, 2008) at 48 et seq.

[34] Among the vast scholarship on the topic see Jurgen Schwarze, *European Administrative Law* (Luxemburg, Sweet & Maxwell, 1992); Mads Andenas & Stefan Zleptnig, *Proportionality: WTO Law in Comparative Perspective*, 42 Tex. Int'l L.J. 371 (2007); Aaron Barak, *Proportionality and Principled Balancing*, 3 Law & Ethics of Human Rights 1 (2010). See recently Caroline Henckels, *Proportionality and Deference in Investor-State Arbitration* (CUP, 2015).

policy action at issue to an intense review or should it grant the respondent host State a so-called 'margin of appreciation'? While there may be other elements in the investment chapter that may provide important clues on such question (for example, the express recognition of the contracting parties' right to regulate), the intensity of the review represents another important (and unclear) variable in the determination of what constitutes indirect expropriation.

In conclusion, paragraph 2 fails to clarify the nature of the case-by-case inquiry introduced therein as well as the relationship between the 'case-by-case inquiry' and the effect-based test put forward in paragraph 1.

5 ACT IV: THE ANNEX AND THE RIGHT TO REGULATE CLARIFICATION

The final act of the EU Proposal's attempts to provide a clearer definition of indirect expropriation is embodied in the third and final paragraph of the Annex on Expropriation. Paragraph 3 states as follows:

> For greater certainty, except in the rare circumstance when the impact of a measure or series of measures is so severe in light of its purpose that it appears manifestly excessive, non-discriminatory measures of a Party that are designed and applied to protect legitimate policy objectives, such as the protection of public health, safety, environment or public morals, social or consumer protection or promotion and protection of cultural diversity do not constitute indirect expropriations.

This paragraph appears to incorporate the concept of the right to regulate in the public interest (or 'police powers'). It introduces a general principle according to which non-discriminatory measures designed and applied to protect legitimate policy objectives do not constitute indirect expropriations except in the rare circumstance when the impact of the measure is so severe in light of its purpose that is appears manifestly excessive.

The most effective interpretation of the third paragraph of the Annex is to read it as establishing a presumption in the context of the case-by-case analysis under the second paragraph according to which non-discriminatory measures for a public purpose do not constitute indirect expropriation. It is a rebuttable presumption as even such measures may constitute indirect expropriation in the exceptional case of a measure that imposes such manifestly excessive burdens (on the investment?) compared to the measure's public policy benefits.

It is not clear, however, whether the case-by-case analysis described in paragraph 2 would then only be applicable for purposes of determining the exceptional case (according to a cost/benefit balancing test) or more broadly in order to assess whether a measure falls under the general presumption (i.e., it is a non-discriminatory measure designed and applied to protect a legitimate public policy).

A second related issue regarding the right to regulate clarification revolves around the issue of determining when a non-discriminatory measure may be

said to be 'designed and applied' to protect a legitimate public policy. What is the applicable test to determine whether a specific host State conduct qualifies for the presumption in paragraph 3? Once again, there exist several options including good faith, reasonableness, necessity and even cost/benefit balancing. First, it may be enough that the measure at issue be a good faith attempt at addressing a legitimate public policy concern. In international investment law, for example, this test is often linked with the prohibition of arbitrariness (at least in customary international law)[35] and with so-called self-judging clauses.[36]

Second, the language chosen in paragraph 3 may entail an assessment of whether the measure at issue is reasonably linked with a legitimate public policy aim pursued by the host State. The test of reasonableness focuses on 'a sufficient causal link between the legitimate objective sought and the behaviour that one seeks to establish as reasonable'.[37]

Third, paragraph 3 may be interpreted as requiring the more demanding 'necessity' or 'least restrictive alternative' test, whereby the non-discriminatory measure chosen by the host State entails the lowest possible burden to achieve the specific policy goal. In this context, the interpreter could rely on the express recognition of the contracting parties' right to regulate "through measures necessary to achieve legitimate policy objectives" included in Article 2.1 of the proposed Investment Chapter. However, the reference to 'necessary' in the context of the general provision on the right to regulate, but not in the right to regulate presumption in the Annex on expropriation may not prove conclusive either way. On one hand, it could be argued that the right to regulate presumption in the Annex should be read in line with the general provision on the right to regulate in Article 2, thus requiring the application of the necessity test in order for the right to regulate presumption to apply. On the other hand, one could also argue that the omission of the term 'necessary' in the Annex is evidence of the contracting parties' willingness to set a lower threshold for purposes of the application of the right to regulate presumption.

Lastly, the applicable test to determine whether a specific host State conduct qualifies for the presumption in paragraph 3 of the Annex may involve cost/benefit balancing. This reading may be supported specifically if one reads the case-by-case analysis described in paragraph 2 of the Annex as involving such balancing. Furthermore, the apparent reference to cost/benefit balancing as the basis for reversing the right to regulate presumption (albeit a case involving a 'manifestly excessive' lack of balance) may also support the argument pointing to cost/benefit balancing as constituting the applicable test for purposes of

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[35] *See* Patrick Dumberry, *The Prohibition against Arbitrary Conduct and the Fair and Equitable Treatment Standard under NAFTA Article 1105*, 15 JWIT 117 (2014).

[36] *See* Stephan Schill & Robyn Briese, *'If the State Considers': Self-Judging Clauses in International Dispute Settlement*, in A von Bogdandy & R Wolfrum (eds) 13 *Max Planck Yearbook of United Nations Law* (Brill, 2009) 61-140.

[37] Olivier Corten, *The notion of 'reasonable' in international law: legal discourse, reason and contradictions*, 48 ICLQ 613, 623 (1999).

establishing the applicability of the right to regulate presumption, in the first place.

Accordingly, while the aim of paragraph 3 is clearly to introduce a mechanism to safeguard host States' right to regulate in the public interest, the scope and operation of such mechanism remain unclear.

6 CONCLUDING REMARKS

There is no doubt that the underlying aim of the EU Proposal on indirect expropriation is praiseworthy. Greater clarity with regard to the investment protection standards established in international treaties reduces some of the legal controversies that have recently inflamed foreign investor-host State relations, involved high arbitration costs and undermined the overall legitimacy of the international investment regime.

However, the paper has tried to show that the attempt to instil 'greater certainty' in the notion of indirect expropriation undertaken by the EU in its recent TTIP proposal (as well as by many other countries in other treaty contexts) risks to prove unsuccessful. The Annex refers more or less expressly to a variety of legal approaches without clarifying their contour and relationship.

Accordingly, Article 5 and the first paragraph of the Annex refers to the measure's 'effect' and the concept of 'substantial deprivation', very much along the lines of the so called 'sole-effect' doctrine developed by investment tribunals. The second paragraph of the Annex refers to a case-by-case inquiry involving a broader set of relevant factors including principally the measure's economic impact and character and seems to rely on some kind of balancing exercise aimed at determining the existence of an indirect expropriation. Finally, the third paragraph of the Annex refers to the right to regulate and appears to establish the presumption that non-discriminatory measures designed and applied for a legitimate public purpose do not constitute an indirect expropriation except in the rare case where such measure imposes manifestly excessive burdens on the investment compared to the measure's public policy benefits. There is very little or no indications on how the three approaches interact with one another and thus operate in practice.

Moreover, the contours of each approach remains in some important respects unclear. For example, the reference to the substantial deprivation of the 'fundamental attributes of property' remains largely unexplored. For example, will the deprivation inquiry focus on 'rights' or on 'value'? The type of balancing exercise that should be carried out in the case-by-case inquiry is also not specified. Will a tribunal need to apply a cost-effectiveness (necessity) test or a cost/benefit (proportionality in the strict sense) test? Equally, the applicable test to determine whether a specific host State conduct qualifies for the right to regulate presumption may be based on various legal concepts such as good faith, reasonableness, necessity and cost/benefit balancing.

Of course, legal certainty is a relative concept and it would be illusory to expect absolute clarity in the regulation of expropriation (particularly at the international level). However, many of the issues that have not been settled in the EU Proposal (as in many other recent investment treaties) are issues too central to remain unresolved. Is indirect expropriation about substantial adverse effect on the investment or is it about the legitimacy and reasonableness of the public policy measure adopted by the host State? Should the right to regulate be subject to a test based on good faith, necessity, or strict cost/benefit balancing? If the underlying purpose, in addition to bringing about greater certainty, is to strike the right balance between affording a high level of protection to foreign investment and safeguarding the host State's right to regulate in the public interest, these questions must be tackled head-on and clearly resolved.

One may argue that the lack of clarity may be due to the specific strategy employed by the EU (and many other countries before it), which tries to find inspiration from past tribunals' practice. Any attempt to codify a doctrine that has developed through a long and complex jurisprudence (such as that of the US Supreme Court or of hundreds of ad hoc investment tribunals) is in itself a herculean feat full of risks and pitfalls. However, I believe the missing piece in the puzzle is a different one. Policy makers, including the EU, have crucially not yet figured out the appropriate balance between investment protection and States' right to regulate. While they have understood the relevant stakes in the debate, they have not yet been able to draw the line between an indirect expropriation (that entails compensation) and a legitimate regulatory measure (that does not). Ultimately, this is because policy makers have not decided what is the main function of investment treaties: is it to protect foreign investments or to subject host countries to certain principles of good public governance? The admittedly imperfect attempt at bringing about greater clarity to the concept of indirect expropriation through the Annex on expropriation is the perfect evidence of this indecision.

In principle, many options are potentially open. However, when it comes to defining such a loaded and complex concept as expropriation, the 'right' approach is in the eyes of the beholder. This author has suggested already two related simple options: (i) limiting the scope of the prohibition on expropriation without compensation to direct or formal takings or (ii) extending the scope of the prohibition on uncompensated expropriation to any governmental measure that has the effect of completely destroying the value of the investment.[38] There are others, of course. What is essential, however, is for policy makers (including the EU), first of all, to identify the underlying purpose of the international investment regime. From that underlying normative premise, all specific rules and standards (like the one on expropriation) will more easily follow suit.

[38] Federico Ortino, *Refining the Content and Role of Investment 'Rules' and 'Standards': A New Approach to International Investment Treaty-Making*, 28 ICSID Review 152, 160 (2013).